ANNUAL REPORT 1967

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Corporate Data

Transfer Agents First National Bank in Dallas, Dallas, Texas
(After April 1, 1968) The Chase Manhattan Bank, N A., New York City

Registrars Texas Bank & Trust Company of Dallas, Dallas, Texas
(After April 1, 1968) First National City Bank, New York City

Common Stock Traded: Over-the-Counter

Annual Meeting: 10 a. m., April 24, 1968, Dallas Room, First National Bank in Dallas

Mailing Address: P O. Box 719, Dallas, Texas 75221

Telephone: Area Code 214 TAylor 4-8121

About the Cover
On the front cover is embossed the new Corporate symbol for The Southland Corporation Variations of it are used by all divisions to more closely identify them with each other and with the Corporation

TO OUR STOCKHOLDERS:

Your Company celebrated its Fortieth Anniversary by continuing to strengthen its leadership in the convenience food store field and again improving its position as one of the largest milk and ice cream processors in the United States. We know that you share with us the sense of accomplishment that comes from establishing all time sales and profit records and, according to the most recent *Fortune* Directory, moving to the thirty-third largest merchandising company in the United States.

As we forecast at our annual meeting last April, Southland's total revenues for the first time passed the half billion dollar mark, amounting to $527,487,890, a 17.2% gain over 1966 revenues of $450,076,356. Our net earnings from operations were $7,214,033, an increase of 28.1% over 1966 earnings of $5,631,912. In addition, as an extraordinary item, we received a nonrecurring tax refund of $520,000 which brought our net earnings for the year to $7,734,033. Based on 3,809,366 shares, the average number outstanding during the year, adjusted for the 3% stock dividend paid in 1967, earnings from operations were $1.89 per share, while total earnings per share were increased to $2.03 after adding the tax refund. This compares with 1966 adjusted per share earnings of $1.49.

In January, 1968 your Board of Directors voted to split our stock on a three-for-two basis. After giving effect to the split, adjusted earnings per share for 1967 were $1.35 and for 1966 were 99 cents. This retroactive adjustment is reflected in all the financial information in this Report.

Cash dividends paid during 1967 were $1,342,085 and in addition a 3% stock dividend was paid in December. In order to maintain our dividend policy of 36 cents a share annually after the stock split, the Directors declared a quarterly cash dividend of 6 cents a share, payable beginning March 20, 1968.

The Company's cash position was improved substantially in December, 1967 through the private placement of $12 million of 5¾% Convertible Subordinated Notes. The proceeds of these notes, which mature in 1987, will be used for working capital and for the purchase of fixed assets. In addition, on January 2, 1968 your Company's cash position was further improved by the takedown of the final $7,500,000 under the terms of the note and credit agreement governing the promissory notes due 1976.

These new funds will enable us not only to accelerate our store building program again in 1968, but also to completely remodel and air condition a sizable number of our older stores. Of course, we will also continue to modernize our milk and ice cream processing plants as has always been our practice. We plan a major expansion of one of our milk processing plants in the greater Los Angeles area, and a substantial enlargement of our ice cream manufacturing facilities at Baltimore, Maryland and at Houston, and McKinney, Texas in 1968.

Early 1967 trends indicated a significant increase in both store sales and profits over 1966. We are grateful that these increases continued throughout the year, particularly since they came not only from new stores, but also from a remarkable 7.9% improvement in our average sales per store.

During 1967, due to the cost of long-term mortgage money, we supplemented our real estate financing to further store expansion, by selling and leasing back approximately $7.8 mil-

lion of new stores, and we have, in addition to mortgage commitments, sale and leaseback commitments for stores valued at $4 million in 1968.

As many of you know, the entire dairy industry experienced rather serious problems during the year, and our dairy operations were certainly no exception. The problems were a result primarily of the higher prices paid to milk producers for raw milk, and were compounded by increases in other costs and by continuing resistance on the part of the consumer to rising food costs. It was not until the latter part of the year that our profits were partially restored, but we are delighted to report that in most areas of the country the situation has now improved significantly, and we expect this trend to continue throughout 1968.

Our Chemical Division, while still small in terms of overall sales, made excellent progress during the year, and we plan to continue the expansion of this part of our business both through internal growth and acquisition.

Our Ice Operations for the first time in twenty years brought substantially increased profits, and we are greatly encouraged by the outlook for the market of processed packaged ice both to our own stores and to other customers.

We are very pleased with the ability of our organization to meet the challenges of growth. We continue to concentrate on expanding and broadening our training programs in order to provide personnel capable of assuming responsible positions throughout the Company.

While, of course, there remain problems in both the convenience food store field and the dairy industry, we are confident of our ability to stay in the forefront in both of these major areas of our business. Particularly, we feel that the convenience store field in the United States has great potential for continued rapid growth. Estimates at year end indicate that this segment of the retail food business operated almost 7,000 stores with sales of approximately 1.2 billion dollars and the 1975 forecast indicates 20,000 stores and sales of 3.4 billion dollars. We at Southland certainly intend to maintain our leadership in this extremely fast-growing field.

We are grateful for the hard work, the loyalty and the dedication of our nearly 14,000 employees, for we know that they are the real secret of our success. Our thanks also are extended to our millions of customers, our thousands of suppliers and to all of our stockholders for their continuing support and confidence.

Very sincerely yours,

John P. Thompson

John P. Thompson *President*

H. E. Hartfelder

H. E. Hartfelder *Executive Vice President*

STORE OPERATIONS

Sales and profits again hit an all time high in 1967, but perhaps of more consequence is the fact that it marked the year in which many innovations and experiments, proven at the division level, were refined and adopted nationally, adding momentum of lasting significance to certain important facets of our business.

It is now apparent that our intensive merchandising efforts begun three years ago have increased average store sales not only in stores newly opened for business, but also in stores which have been in operation for some time. Sales increases in existing stores yield proportionately higher profits and we feel that the foundations for continuing increases have been well established.

The venture into a new and untried semi-frozen carbonated soft drink in mid 1965 by our Southwestern Division has proved to be a most profitable decision. This drink, sold under the name "ICEE" or under our own trademark "SLURPEE", is a particular favorite of the "new generation" and also with the "young at heart". Sales of this drink added materially to our overall volume, and the traffic generated added substantial "plus" sales of many standard 7-Eleven items. Sales of "ICEE" and "SLURPEE" were an astounding 150 million cups even though dispensers were not installed in all of our stores until mid-year.

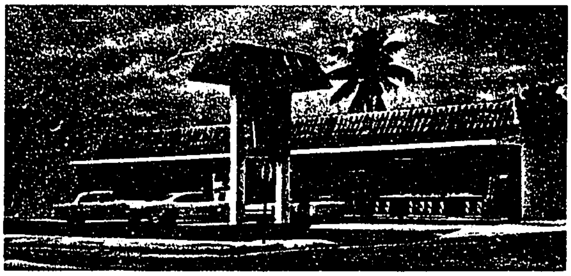
We are continually looking for additional new and exciting items, constantly experimenting with new merchandising programs and techniques and giving ever greater attention to regional preferences. In many areas where customers want them, delicatessen items, sliced-to-order luncheon meats and cheese, fresh meats, hot coffee, fresh bakery goods, shotgun shells, and Christmas trees are sold. In most of our stores we feature many neighborhood services such as TV tube testing machines, key making machines and TV rentals. In addition, we are told that our stores are the largest chain retailer of money orders in the United States, one of the three largest purveyors of beer and wine, and among the largest vendors of such diverse items as razor blades, soft drinks, watermelons and candy.

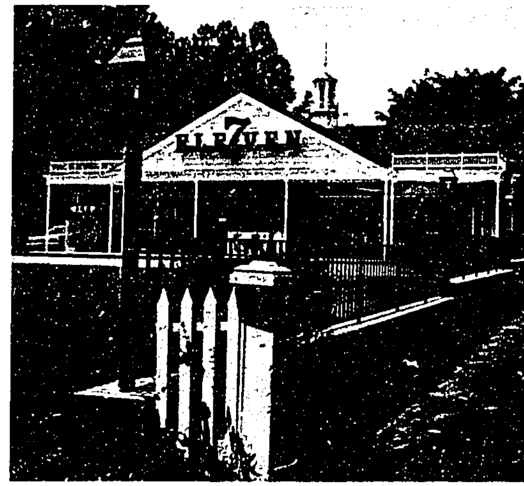
We constantly endeavor to improve the exterior appearance and the interior layout of our stores. Currently, we are seeking to develop a new store design which will be adaptable to all neighborhoods and immediately recognizable to our customers wherever they live or travel.

Following an intensive "SPEAK-UP" customer survey which brought more than ten thousand responses, we have decided to air condition all of our new stores and to remodel, modernize and air condition several hundred of our older stores during 1968.

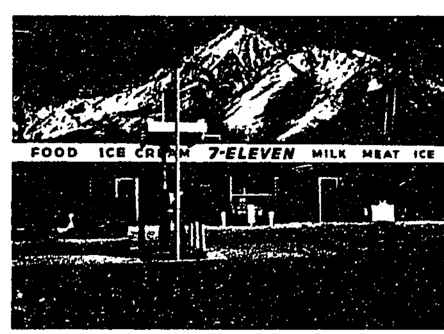
We expect to franchise additional individual stores in certain areas of the country and believe that the advantages of this method of operation more than offset its problems. We will continue to refine individual store franchising and study the

Curved-front dairy and soft drink vaults similar to this one in a Fort Lauderdale, Florida, 7-Eleven store, will be installed in all new units It provides an attractive and inviting display case






FOOD STORE NOW OPEN
ICE


FOOD
7-ELEVEN
MILK
MEAT
ICE

possibility of area franchises, as we also endeavor to improve the operations of our employee-manned stores.

Our method of site selection—the single most important factor governing the success of an individual store—receives constant attention. Twenty-nine full time real estate representatives are employed by your Company and, as a part of their training, seminars are being held at regular intervals to establish and define the many criteria for successful store locations.

Initial estimates of store performance made before the location is acquired are verified against actual performance in a constant effort to maximize successful site selection. The results of this continuing program have been most beneficial and have reduced materially the "lag time" between store opening and profitable operation.

Our expansion during 1967 saw the largest number of our stores opened in California, and we expect that this will be so for the next several years. Additionally, we continue to grow rapidly in the eastern United States, and we are intensifying our expansion efforts in the Midwest where many major metropolitan centers are yet to be served properly by the convenience store. We believe that great opportunities exist in these areas.

At the close of 1967, your Company had 2,605 stores open for business, a net gain of 284 stores during the year. The decision to forego certain expansion due to the very high cost of real estate financing resulted in somewhat fewer store openings than during each of the preceding three years. This reduction in the number of new stores, however, afforded management additional opportunity to analyze and revaluate operating procedures and to concentrate on their improvement, with most encouraging results.

Surveys have been made of the potential for convenience food stores in the Dominion of Canada, and during 1968 we expect to experiment on a small scale in Vancouver, Edmonton, Calgary, and Winnipeg. While this expansion will be relatively insignificant in our overall picture during the next few years, if we are correct in our projections Canada eventually could become an important factor in store operations. The European market is also being surveyed. While restrictions on foreign investment may delay somewhat our efforts in this direction, we are confident that the results of this effort will not go unrewarded.

Believing as we do that convenient location and fast, courteous service from a well merchandised and warm, friendly store are the cornerstones of our success, we are constantly refining those techniques which have proved successful and are always looking for other opportunities to better serve our customers.

A variety of exterior store designs have been built in harmony with the tradition and architecture of their areas At the same time we seek to develop a new store design adaptable to all neighborhoods that our customers will recognize instantly wherever they live or travel All new stores will be air conditioned and several hundred older stores will be remodeled and air conditioned in 1968

SOUTHLAND STORE OPERATIONS

Division Offices:

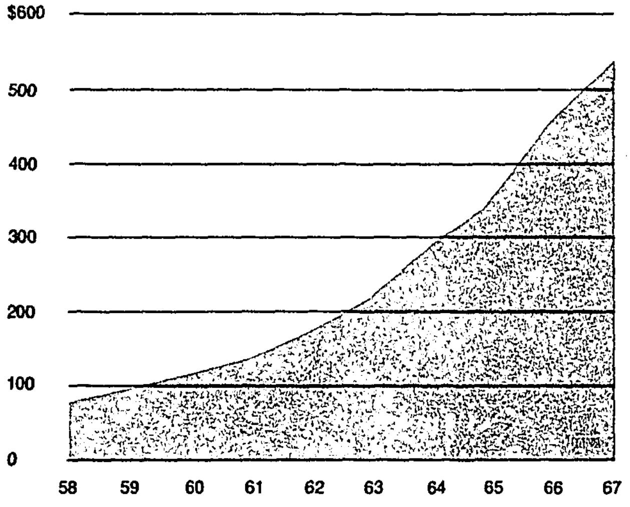
- Eastern Division
  Washington, D. C.
- Southern Division
  Atlanta, Georgia
- Southeastern Division
  Miami, Florida
- Southwestern Division
  Dallas, Texas
- Mountain Division
  Denver, Colorado
- Western Division
  San Diego, California
- New Areas Division
  Chicago, Illinois

SOUTHLAND DAIRY OPERATIONS

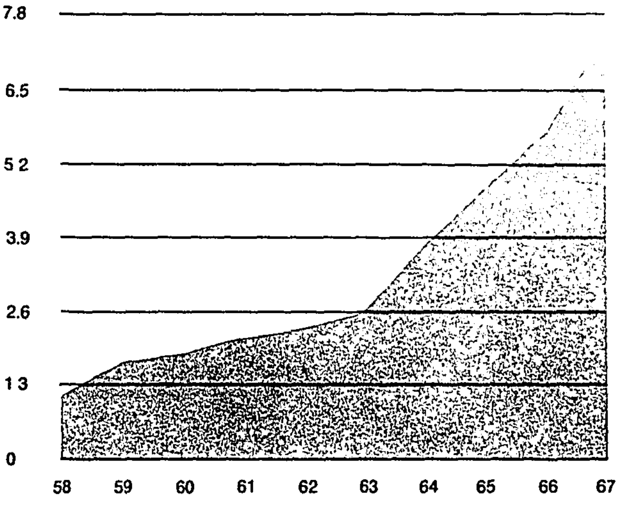
Division Offices:

- Harbisons Dairies
  Philadelphia, Pa.
  Brand Names: Harbisons, Delvale
- Embassy Dairies
  Washington, D. C
  Brand Name: Embassy
- Velda Farms
  Miami, Florida
  Brand Name. Velda Farms
- Midwest Farms
  Memphis, Tennessee
  Brand Names.
  Midwest Farms,
  Fortune
- Oak Farms
  Dallas, Texas
  Brand Names: Oak Farms,
  Camellia, Goble's
- Cabell's
  Dallas, Texas
  Brand Names Cabell's,
  Cooper Farms
- Adohr Farms
  Los Angeles, California
  Brand Name Adohr Farms
- Spreckels
  San Francisco, California
  Brand Name: Spreckels

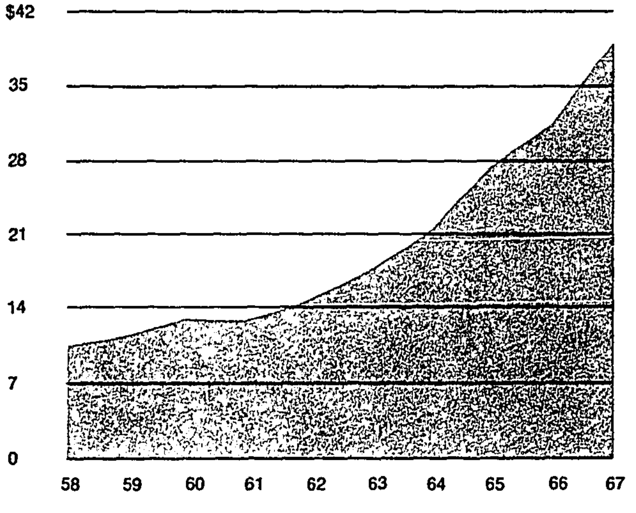
TOTAL REVENUES
(In Millions)



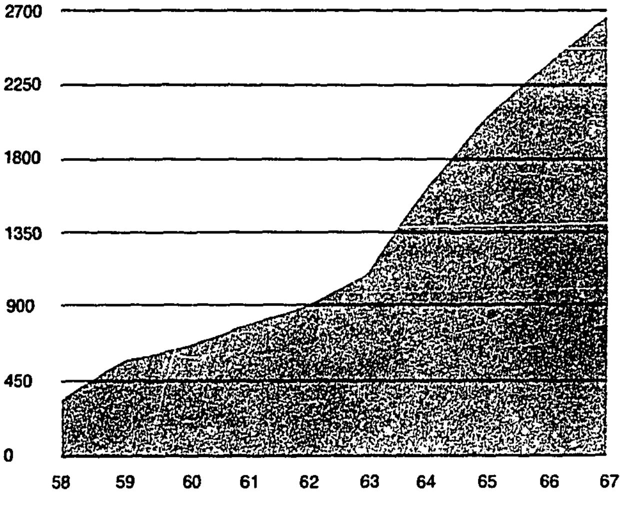
NET EARNINGS (After Tax) (Before Special Items)
(In Millions)



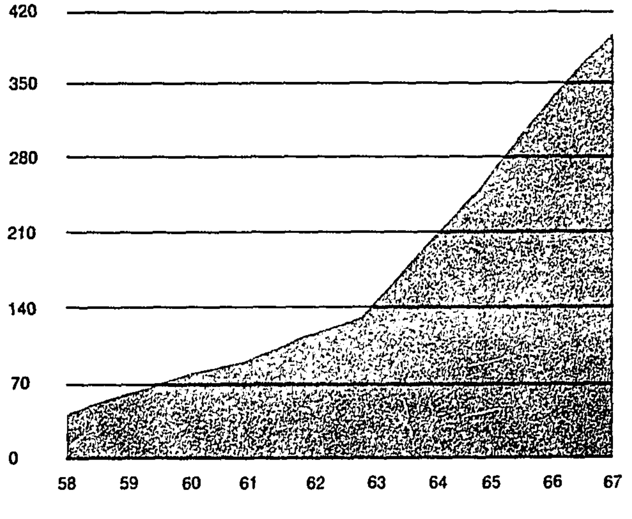
STOCKHOLDERS' EQUITY
(In Millions)



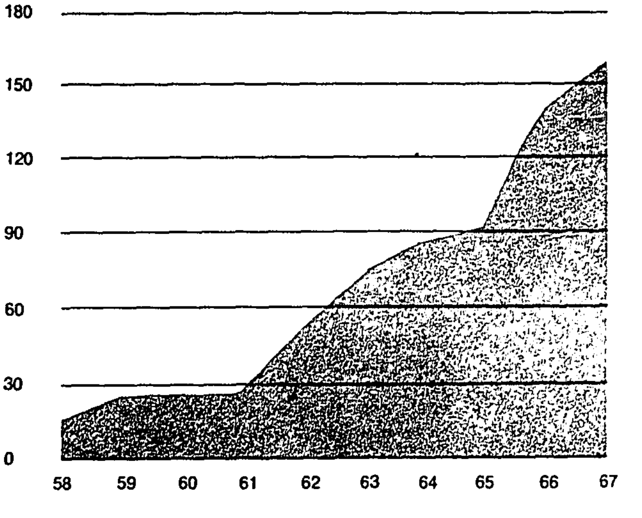
NUMBER OF STORES



STORE SALES
(in Millions)



DAIRY SALES (Including Intercompany Sales)
(In Millions)



10 YEARS OF GROWTH

THE SOUTHLAND CORPORATION AND SUBSIDIARIES

	1958	1959	1960
Total Revenues*	$ 67,943	$ 97,635	$ 114,360
Net Earnings (Note 2)*	1,201	2,021	1,586
Net Working Capital*	4,728	4,681	5,970
Property, Plant & Equipment (Net)*	8,160	11,121	11,251
Long-Term Debt*	3,275	4,938	5,178
Stockholders' Equity*	9,982	10,936	12,000
Cash Dividends (Note 4)	247,002	310,966	376,469
Average Shares Outstanding (Note 3)	5,098,484	5,104,456	5,113,818
Number of Stockholders (Note 4)	284	300	317
* (000 Omitted)			
Per Share of Common Stock (Note 3):			
Net Earnings	.24	.40	.31
Cash Dividends (Note 4)	.05	.06	.07
Book Value	1.96	2.14	2.35
Earnings as a percent of Stockholders' Equity	12.03	18.48	13.22

NOTES:

(1) Includes The Southland Corporation and subsidiaries Data for businesses acquired under the pooling of interests concept have been included for years prior to their acquisition by The Southland Corporation

(2) Net earnings include special items of $449,000 (addition) in 1959, $393,000 (deduction) in 1961 and $520,000 (addition) in 1967.

(3) Calculations of per share information are based upon the average number of shares outstanding during the respective years after giving effect to subsequent stock dividends, stock splits and shares issued in exchange for businesses acquired under the pooling of interests concept.

(4) Cash dividends and number of stockholders relate to the parent company only.

DAIRY OPERATIONS

While continuing to improve their substantial position in the twenty principal market areas in which they do business, our dairies initiated the most extensive effort in their history to develop a uniform product identification for national use. We strongly believe that their regional brand names enjoy intense customer loyalty and wide public acceptance. However, over the years it became apparent that the preservation of these brand names and diverse package designs failed to capitalize on the national scope of our dairy operations. To solve this problem and in recognition of the fact that the American people are the most mobile in the world and turn to familiar brands, wherever they may be, the prominent industrial design firm of Frank Gianninoto & Associates was engaged in mid-1966. Mr. Gianninoto was assigned the task of designing an instantly recognizable symbol to be the dominant feature on all dairy packaging while preserving each division's brand name. After thorough study, a unique, flowing, contemporary design—two-color coded for each different product—was adopted. We feel that this new trademark will immediately identify the origin of our dairy products even though the name appearing under the symbol may be Oak Farms, Adohr Farms, Midwest Farms, Embassy, Harbisons, Spreckels, or Velda Farms.

This "new image" was first introduced in Memphis, Tennessee in June, 1967, and its wide-spread public acceptance has far exceeded expectations. In conjunction with the inauguration of this new symbol as it progresses on a division by division basis, all trucks are freshly painted and all signs and sales paraphernalia are also changed.

Intensive advertising utilizing all media, and radio, press and television interviews with company executives, have accompanied the promotion of this new packaging, and our quality dairy products and your Company have received much valuable publicity. Our new image will be established in all markets by April 15, 1968. The new packaging increased sales upon its introduction, and, even more important, these increases have been retained after its first impact. As a part of this overall program, redesigned packaging featuring the new trademark will be introduced in late spring on our ice cream and other frozen products, and we are confident it will receive like public acceptance.

As a part of our continuing effort to increase efficiency and reduce costs, modernization, consolidation and rearrangement of certain of our dairy facilities was accomplished during 1967. Our Memphis, Tennessee, Houston, Texas, and Miami, Florida facilities were extensively modernized. We were fortunate during 1967 to be able to acquire two milk plants and one ice cream plant in the metropolitan Los Angeles area, thereby avoiding the necessity of building a completely new facility to replace our Los Angeles plant on which the lease will expire within the next two years. After remodeling and modernizing these facilities, their capacity will be doubled, and our cost of

Colorful dairy cartons are designed so that each product displays its own distinctive color combination for easy identification. Brand names are subordinate to the trademark design so customers can quickly identify the package as being from a Southland dairy division


CHOCOLATE MILK
EGG NOG
Adohr Farms
FRESH CHURNED BUTTERMILK
Midwest Farms
LOW-FAT MILK
Oak Farms
EGG
Adohr Farms
Oak Farms
CULTURED BUTTERMILK
Oak Farms
Embassy
HOMO
VITAMIN D MILK
Embassy
Velda Farms
ORANGE DRINK
Velda Farms
Oak Farms
SOUR CREAM
Oak Farms
SMALL CURD CREAMED
COTTAGE CHEESE
Oak Farms
Sprekels
HOMO
VITAMIN D MILK
Sprekels
Adohr Farms
FRESH CHURNED
BUTTERMILK
Oak Farms
FORTIFIED
Midwest Farms
SKIM MILK
Midwest Farms
Harbisons
HOMO
VITAMIN D MILK
Oak Farms
LARGE CURD CREAMED
COTTAGE CHEESE
Oak Farms
BUTTERMILK
LEMONADE
ORANGE

operation will be materially reduced. Based on market surveys and population projections, our southern California requirements will be satisfied for at least five years.

While sales during 1967 increased substantially, profits were below our expectations for several reasons. The dairy industry as a whole found itself in a unique price squeeze. The price of raw milk increased as did other costs, while profit margins declined as a result of intense competition in the market and the resistance of the housewife to price increases in all food items. Milk, a basic food item, was particularly susceptible to this resistance. Fortunately, however, during the latter part of the year margins improved in most of our major markets, and, by continuing to reduce costs and improve the efficiency of operations, dairy profits should be substantially better in 1968.

Chemical Division

Although still a small part of dairy operations, the profits of the chemical division increased 125% over the preceding year, while sales doubled.

Since its inception in early 1965, the division has directed its efforts toward supplying cleansing agents, detergents, food stabilizers and flavor concentrates to your Company's store and dairy operations. Today, however, particular emphasis is being placed upon increasing sales volume to the dairy, baking, brewing, bottling and general food processing industries, and resident sales offices have been opened in Sacramento and Long Beach, California, Baltimore, Maryland, Chicago, Illinois and Atlanta, Georgia.

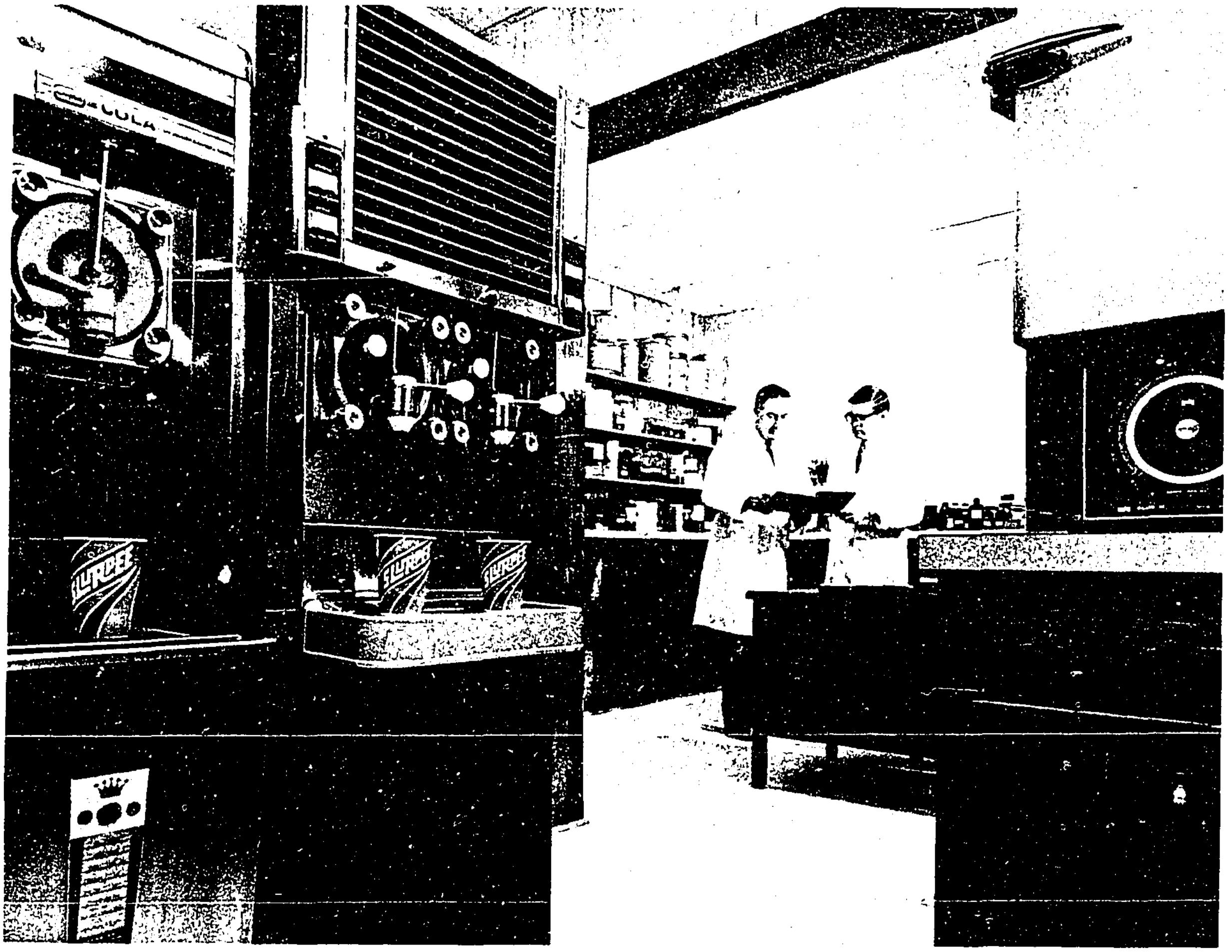
Considerable research and development is continuing in an effort to enlarge product lines, and recently a new facility was acquired in Dallas, Texas which will enable this fast growing division to consolidate its operations and to expand its quality control and research laboratory.

ICE OPERATIONS

For the first time in twenty years, the sales and earnings of ice operations rose sharply. Efficiencies brought about by consolidation and modernization of older facilities were reflected in operations, and retail sales resulting from increased consumer acceptance of processed packaged ice, marketed under our tradename "REDDY ICE", continue to more than offset the decline in large tonnage wholesale business.

Added emphasis is being placed on the expansion and automation of facilities to increase production capacities while reducing costs. A completely new facility near Miami will be opened by late spring to serve the entire southern Florida market. Additionally, we are firmly convinced that there is a considerable opportunity in several other major metropolitan markets, through small but efficient manufacturing and packaging plants, to serve profitably both our stores and other customers with quality ice products.

The colorful, flowing design for new dairy product packages was displayed in a variety of ways as our "new image" was introduced market by market. All delivery trucks were freshly painted to reflect the changed design



Chemical division laboratory develops new flavor concentrates for "SLURPEE" and "ICEE" semi-frozen carbonated soft drinks, conducts research designed to broaden the division's product line, and maintains quality control checks on dairy products. Modern processed packaged ice, under the "REDDY ICE" tradename has enabled ice operations to expand sharply.

LIABILITIES AND STOCKHOLDERS' EQUITY

	December 31 1966	December 31 1967
CURRENT LIABILITIES:		
Notes payable to banks	$ 837,401	$ –
Long-term debt due within one year	1,292,017	4,409,437
Accounts payable and accrued expense	27,937,168	36,546,607
Federal income tax	1,115,926	940,944
Total Current Liabilities	$ 31,182,512	$ 41,896,988
DEFERRED CREDITS (Note 3)	3,116,129	4,532,665
RESERVES FOR SELF INSURANCE	366,201	640,674
LONG-TERM DEBT (Note 4):		
5¾% Promissory notes due 1976	$ 21,500,000	$ 17,421,875
4%-7% Real estate notes	17,775,436	21,317,921
5% Convertible subordinated notes due 1984	11,250,000	11,250,000
5¾% Convertible subordinated notes due 1987	–	12,000,000
4½% Cumulative income debentures due 1979	856,700	–
	$ 51,382,136	$ 61,989,796
STOCKHOLDERS' EQUITY (Notes 4 and 5):		
Common stock, $.01 par value, authorized 10,000,000 shares, issued and outstanding 5,776,514 shares in 1967 (Note 7) and 3,677,700 shares in 1966	$ 36,777	$ 57,765
Additional paid-in capital	12,392,444	16,894,723
Earnings retained in the business	18,346,726	21,041,902
	$ 30,775,947	$ 37,994,390
CONTINGENCIES AND COMMITMENTS (Note 6)		
	$116,822,925	$147,054,513

CHANGES IN
NET WORKING CAPITAL 1967

THE SOUTHLAND CORPORATION AND SUBSIDIARIES

WORKING CAPITAL, DECEMBER 31, 1966		$41,248,169
Additions:		
Net Earnings	$ 7,734,033	
Depreciation	4,134,000	
Deferred Credits	1,416,536	
Long-Term Debt	10,607,660	
Exercise of Stock Options	835,835	
Other (net)	396,389	
	$25,124,453	
Deductions:		
Cash Dividends	$ 1,342,085	
Plant & Equipment	23,974,178	
	$25,316,263	
		(191,810)
WORKING CAPITAL, DECEMBER 31, 1967		$41,056,359

STATEMENT OF CONSOLIDATED STOCKHOLDERS' EQUITY

THE SOUTHLAND CORPORATION AND SUBSIDIARIES

	Year ended December 31, 1967	
COMMON STOCK:		
Balance January 1, 1967	$ 36,777	
Exercise of stock options	613	
3% Stock dividend	1,120	
Stock split—3-for-2 (Note 7)	19,255	
Balance December 31, 1967		$ 57,765
ADDITIONAL PAID-IN CAPITAL:		
Balance January 1, 1967	$ 12,392,444	
Exercise of stock options	835,222	
3% Stock dividend	3,686,312	
Stock split—3-for-2 (Note 7)	(19,255)	
Balance December 31, 1967		16,894,723
EARNINGS RETAINED IN THE BUSINESS:		
Balance January 1, 1967	$ 18,346,726	
Net earnings for the year	7,734,033	
	$ 26,080,759	
Less:		
Cash dividends	$ 1,342,085	
3% Stock dividend	3,696,772	
	$ 5,038,857	
Balance December 31, 1967		21,041,902
TOTAL STOCKHOLDERS' EQUITY (Notes 4 and 5)		$ 37,994,390

See notes to financial statements

NOTES TO FINANCIAL STATEMENTS
Year ended December 31, 1967

THE SOUTHLAND CORPORATION AND SUBSIDIARIES

Note 1—Principles Of Consolidation:

The financial statements include the assets, liabilities, sales, and costs and expenses of all domestic subsidiaries. A foreign subsidiary which is not significant has not been consolidated Intercompany transactions have been eliminated in consolidation.

Note 2—Investment In Property:

Investment in property includes land and buildings to be mortgaged under long-term obligations or to be sold to outsiders. Current working funds are used in the construction of new facilities. Periodically throughout the year, the Company sells completed facilities to outsiders for cash and/or arranges for long-term borrowings. The Company expects that cash funds will be realized within a twelve month period for these assets

Note 3—Deferred Credits:

For financial reporting purposes, investment credits relating to leased and purchased property and equipment, which are allowed as credits against federal income taxes, are taken into income ratably over the useful life of the assets or the term of the leases, respectively.

Deferred federal income taxes result from the use of accelerated depreciation methods for tax purposes

	Investment credit	Deferred federal income taxes	Other	Total
Balance January 1, 1967 . .	$2,151,952	$ 838,347	$125,830	$3,116,129
Reclassification of federal income tax credit	–	(124,420)	124,420	–
Provided for the year . . .	687,097	1,040,731	64,000	1,791,828
Taken into income	(375,292)	–	–	(375,292)
Balance December 31, 1967 .	$2,463,757	$1,754,658	$314,250	$4,532,665

Note 4—Long-Term Debt:

At December 31, 1967, long-term debt and amounts due within one year were as follows·

	Amount outstanding	Current portion	Balance included in long-term debt
5¾% Promissory notes due 1976 . .	$20,000,000	$2,578,125	$17,421,875
4%-7% Real estate notes . . .	23,149,233	1,831,312	21,317,921
5% Convertible subordinated notes due 1984	11,250,000	–	11,250,000
5¾% Convertible subordinated notes due 1987 . . .	12,000,000	–	12,000,000
	$66,399,233	$4,409,437	$61,989,796

In accordance with the terms of the 5¾% Promissory notes, the final $7,500,000 was taken down on January 2, 1968.

Approximately 30% of the net carrying value of property, plant and equipment is mortgaged. These real estate notes have maturity dates from 1968 to 1987.

The 5% and the 5¾% convertible subordinated notes may, at the option of the holders, be converted at any time into common stock of the Company at the rates, respectively, of 49.19 and 40 13 shares of stock for each $1,000 principal amount of notes. These rates decrease to 43.29 and 38.15 shares on January 1, 1975 and December 1, 1977, respectively At December 31, 1967, there were 1,034,948 shares of common stock reserved for the conversion of notes. Principal payments are due annually beginning in 1975 and 1978, respectively, in amounts equal to 10% of the aggregate principal amount of notes outstanding one year prior to the date of the first required payment.

The Company has elected not to recognize as debt discount an amount assigned to the convertibility feature of the 5¾% convertible subordinated notes. If such discount had been recognized, total discount estimated at $1,620,000 would have been recorded at December 19, 1967, the date such notes were sold to institutional investors, with a corresponding credit to additional paid-in capital. Amortization of such discount on a straight-line basis would approximate $81,000 on an annual basis and would have decreased net earnings by $2,663 for the year ended December 31, 1967. The Company does not intend to recognize such discount unless it is required to do so in order to comply with generally accepted accounting principles, and if so required, the amount ultimately recognized may be different from that stated above

The aggregate amount of long-term debt maturities for the five years following December 31, 1967, is: 1968—$4,409,437, 1969—$5,217,874; 1970—$5,292,735; 1971—$5,335,059, 1972—$5,348,460.

The loan agreements under which the promissory notes and the convertible subordinated notes were issued place certain restrictions on the payment of cash dividends. Under the most restrictive of these provisions, retained earnings totaling $4,871,000 at December 31, 1967, were not so restricted. Other provisions of the loan agreements include requirements as to maintenance of working capital and net worth. The Company has complied with these requirements.

Note 5—Stock Options:

At December 31, 1967, options for 268,521 shares of the Company's stock, at prices ranging from $1 94 to $18.17 were outstanding, of which 153,555 shares were exercisable. During 1967, 94,612 shares were issued upon exercise of options at prices ranging from $1 85 to $18 17; options were granted for 60,661 shares at $14 40 per share; and options for 11,155 shares expired or were cancelled.

An additional 32,754 shares are available for future grants under the employees' stock option plan

Note 6—Lease Commitments:

Certain of the property and equipment used in the Company's business is leased Minimum rental payments for 1968 under lease agreements in effect as of December

31, 1967, exclusive of taxes and insurance payable by the Company, approximate $12,069,000 for real estate leases and $8,064,000 for equipment leases.

Real estate leases range generally from 15 to 20 years and equipment leases from 5 to 10 years. Future minimum annual rental payments for leases in effect at December 31, 1967 are approximately as follows for each year specified.

Year	Real Estate	Equipment	Total
1972	$10,223,000	$5,153,000	$15,376,000
1977	7,450,000	55,000	7,505,000
1982	4,369,000	–	4,369,000
1987	1,524,000	–	1,524,000
1992	542,000	–	542,000

Note 7—Subsequent Event:

On January 24, 1968, the Board of Directors approved a 3-for-2 stock split to be effected in the form of a 50% stock dividend payable February 20, 1968, to holders of record January 31, 1968.

Retroactive effect has been given to this stock split in the financial statements and, accordingly, all share and per share information has been adjusted to reflect this stock split.

Note 8—Earnings Per Share:

The earnings per share information is based on the average number of shares outstanding in each year, adjusted for stock dividends and the 3-for-2 stock split in January, 1968 (Note 7).

The pro forma earnings per share information is based on the assumption that the 5% and 5¾% convertible subordinated notes outstanding at December 31, 1967, had been converted into shares of common stock at the stated conversion rates at the earliest possible dates, that the related interest requirements had been eliminated and that outstanding stock options had been exercised.

Note 9—Reclassification:

Certain reclassifications have been made to amounts previously reported for the year ended December 31, 1966, to conform to classifications currently in use.

Note 10—Classification Of Cost Of Sales And Expenses In Annual Report To The Securities And Exchange Commission:

Cost of goods sold, including buying and occupancy expenses	$408,466,625
Selling, general and administrative expenses	99,997,251
Interest expense	3,296,969
Contributions to employees' savings and profit-sharing fund	1,466,012
	$513,226,857

TOUCHE, ROSS, BAILEY & SMART

DALLAS FEDERAL SAVINGS BUILDING
DALLAS, TEXAS 75201

Board of Directors and Stockholders,
The Southland Corporation,
Dallas, Texas.

We have examined the accompanying consolidated balance sheet of The Southland Corporation and subsidiaries as of December 31, 1967, and the related statements of earnings and stockholders' equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements referred to above present fairly the consolidated financial position of The Southland Corporation and subsidiaries at December 31, 1967, and the consolidated results of their operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Touche, Ross, Bailey & Smart

Dallas, Texas.
February 17, 1968. Certified Public Accountants.

BOARD OF DIRECTORS

Webster Atwell *Partner, Atwell, Grayson & Atwell*

J. Y. Ballard *Vice President / Independent Consulting Engineer*

Walton Grayson, III *Vice President and General Counsel / Partner, Atwell, Grayson & Atwell*

H E. Hartfelder *Executive Vice President*

W. W. Overton, Jr. *Chairman of the Board and Chief Executive Officer of Texas Bank & Trust Company*

Jere W. Thompson *Vice President*

John P. Thompson *President*

Clifford W. Wheeler *Vice President*

OFFICERS

John P. Thompson *President*

H. E. Hartfelder *Executive Vice President*

Jere W. Thompson *Vice President, Store Operations*

M T. Cochran, Jr. *Vice President, Dairy Operations*

Clifford W. Wheeler *Vice President, New Areas*

Walton Grayson, III *Vice President and General Counsel*

J. Y. Ballard *Vice President*

W. K. Ruppenkamp *Treasurer*

J. B Langford *Secretary*

R. G. Smith *Controller*